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SUBJECT: GOG STRUGGLES TO MAKE ENDS MEET

¶1. SUMMARY: The Colom administration arrived in office with a surging economy and a reasonable budget that projected a 2008 fiscal deficit of 1.6% of GDP. On April 1, Guatemala's Congress approved the last of five IDB and World Bank loans necessary to finance the 2008 budget deficit. Finance Minister Fuentes Knight is now searching for ways to pay for a previously undisclosed debt of $262 million that will raise the budget deficit to 2.4% of GDP. Adding to the already difficult fiscal situation is pressure to reduce a petroleum distribution tax and subsidize basic foodstuffs to help Guatemalans cope with surging prices of food and energy (inflation was 9.1% for the year ending March 31). Some medium term relief could come from the successful enactment and implementation of a tax reform proposal that would increase tax revenues from 12.3% to 13.2% of GDP by 2010. END SUMMARY.

Tough Start

¶2. In December 2007 Guatemala's Congress approved a budget for 2008 that called for $5.5 billion in expenditures, a 5.8% increase over ¶2007. Based on this spending and estimated tax revenue, the Finance Ministry projected a 2008 budget deficit of $600 million or 1.6% of GDP. Financing for the deficit was to be primarily via five IDB and World Bank loans; however, these loans were not approved with the overall budget. What was supposed to be a relatively simple process became politicized as Congress grilled Finance Minister Juan Alberto Fuentes Knight over the loans, complaining about the size of administrative expenses needed to service the loans. Four of the five loans were approved by narrow margins in Congress during the first two months of the year. Congress approved the fifth loan, a $100 million World Bank loan to finance security and social programs, on April 1.

¶3. In addition to the difficulty the administration had in winning Congressional approval to finance previously approved spending, the Colom administration discovered $262 million in previously undisclosed spending by the previous government, primarily on infrastructure projects. These were generally highway projects undertaken by the Berger government last year (an election year), aimed at burnishing the electoral credentials of the GANA. The debt amounts to 0.8% of GDP, which will increase the deficit to 2.4% of GDP in 2008. The government plans to ask for an additional emergency appropriation to pay approximately half of this debt, and will reduce spending in the Ministry of Communications to pay for the other half.

Inflation creates additional budgetary pressure

¶4. In addition to the difficulties Guatemala had in securing funds to finance previous obligations and planned spending, additional pressure on the budget is mounting. Surging fuel costs and their ripple effect on transportation costs for other goods and services have injected significant inflationary pressure into the economy. Inflation for the year ending March 31 was 9.1% (as compared to 7.0%

one year ago) with price pressure led by the energy and food sectors. Congress is considering a bill to reduce taxes on petroleum distribution (currently 7% of the tax base) and the administration is considering a number of measures, including subsidies on basic foodstuffs, to alleviate the pressure inflation is placing on the pocketbooks of poor Guatemalans. Implementation of any of these measures will have negative consequences for Guatemala's fiscal balance that can not be quantified at this time.
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New Programs

¶5. Beyond immediate needs, the government would like to begin implementing some of the social and security programs promised during last year's campaign. Social programs high on the agenda include the Student Remittances Program, which would make payments to families of children in Guatemala's poorest 45 municipalities to ensure they attend school, and the Elderly Citizens Program, which would be a pension program for the elderly. On the security side, the government has proposed budget augmentations for the Judicial Branch and the Public Ministry (specifically, the National Institute of Forensic Sciences- INACIF). According to the Finance Ministry, funds to support these projects could be raised through corresponding budget cuts in other areas or by securing an additional $40 million loan from the Central American Bank for Economic Integration. In addition, on April 8, the government announced its intention to purchase six Brazilian "Super Tucano" aircraft and ten speedboats to assist with drug interdiction. The cost and source of financing for these acquisitions has not been disclosed.

Tax reform package could increase revenues

¶6. On March 17, Colom's economic team unveiled a tax reform proposal that could, if approved and successfully implemented could raise tax revenues from 12.3% to 13.2% of GDP. Finance Minister Fuentes Knight explained that the basic idea of the plan is to lower marginal tax rates and eliminate exemptions. In this way, he hopes to simplify the tax code, eliminate many opportunities for evasion, improve collections and raise overall revenues. The proposal lowers the corporate tax rate from 31% to 25% and lowers the percentage of sales that can be written off as expenses from 97% to 95%. (Note: this provision is meant to ensure that even loss-generating companies pay some income tax. End note.) Proposed changes to individual income tax rates are more drastic. The current range of tax brackets (from 15% to 31%) will be replaced by two rates: 5% for annual income up to 240,000 Quetzales (approximately $32,000) and 7% for incomes above that amount. According to Fuentes Knight, the elimination of deductions would more than make up for the large reduction in the tax rate. He projects the reform proposal will increase tax revenue by $370 million per year by 2010.

¶7. COMMENT: Guatemala's sound macroeconomic fundamentals, historically conservative fiscal policy and flexible exchange rate should work together to prevent a slightly higher fiscal deficit from negatively impacting credit ratings or the broader economy. Current pressure on the budget is a result of an unusual confluence of factors including the hidden debt and inflation pressures that should abate when energy prices stabilize. The tax reform proposal, if implemented, could also eventually provide the Government with some relief to current budgetary pressure and additional flexibility to pursue social and security programs. Fuentes Knight has proposed a modest reform, hoping to avoid opposition from powerful business groups. The private sector has expressed provisional support for the proposal, although some business leaders are questioning the elimination of specific deductions. The administration's difficulty in convincing Congress to pass loans in support of a previously approved budget suggests it may have an uphill battle to pass tax reform. In the meantime, the Colom administration will need to carefully weigh its desire to increase social spending against the need to maintain macroeconomic stability and a manageable fiscal deficit.